March 16, 2004

Financial Management

Assets Depreciation Reported on the U.S. Army Corps of Engineers FY 2002 Financial Statements (D-2004-059)

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Acronyms

CEFMS	Corps of Engineers Financial Management System
COEMIS	Corps of Engineers Management Information System
DEPREVER	Depreciation Verification Report
ER	Engineer Regulation
FMR	Financial Management Regulation
GAO	General Accounting Office
PMA	Power Marketing Administration
IG DoD	Inspector General of the Department of Defense
USACE	U.S. Army Corps of Engineers

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
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March 16, 2004

MEMORANDUM FOR THE AUDITOR GENERAL, DEPARTMENT OF THE ARMY

SUBJECT: Report on Assets Depreciation Reported on the U.S. Army Corps of Engineers FY 2002 Financial Statements (Report No. D-2004-059)

We are providing this report for review and comment. This audit was performed in support of the Chief Financial Officers Act of 1990 (Public Law 101-576), as amended by the Government Management Reform Act of 1994 (Public Law 103-356). We considered management comments on a draft of this report in preparing the final report.

DoD Directive 7650.3 requires that all issues be resolved promptly. The U.S. Army Corps of Engineers comments were responsive. However, for Recommendations A.2., A.3., A.4., and A.5., we request that U.S. Army Corps of Engineers assert to the IG DoD auditors whether all required adjustments were made. For the districts where substantial variances still exist between the depreciation variance report and recorded depreciation, we request that USACE provide the results and reasons for the remaining variances to the Office of the Inspector General of the Department of Defense for review and concurrence. We request that management provide the additional comments by April 16, 2004.

If possible, please send management comments in electronic format (Adobe Acrobat file only) to Auddfs@dodig.osd.mil. Copies of the management comments must contain the actual signature of the authorizing official. We cannot accept the / Signed / symbol in place of the actual signature. If you arrange to send classified comments electronically, they must be sent over the SECRET Internet Protocol Router Network (SIPRNET).

We appreciate the courtesies extended to the staff. Questions should be directed to Ms. Barbara A. Sauls at (703) 604-9129 (DSN 664-9129) or Mr. Kenneth A. Weron at (703) 604-9170 (DSN 664-9170). See Appendix E for the report distribution. The team members are listed inside the back cover.

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Office of the Inspector General of the Department of Defense

Report No. D-2004-059 **March 16, 2004**
Project No. (D2003FH-0042)

Assets Depreciation Reported on the U.S. Army Corps of Engineers FY 2002 Financial Statements

Executive Summary

Who Should Read This Report and Why? U.S. Army Corps of Engineers (USACE) financial managers responsible for the calculation and reporting of depreciation, and persons charged with the preparation of Chief Financial Officers financial statements should read this report. This report discusses problems in the calculation and reporting of accumulated depreciation, and the inadequate disclosure of facts related to the preparation of financial statements.

Background. This report is one of a series of reports to be issued on accounting and financial statements at the U.S. Army Corps of Engineers, Civil Works. The Chief Financial Officers Act of 1990 and the Government Management Reform Act of 1994 require annual financial statement audits of the Department of Defense. As part of the strategy to implement these laws, the Office of Management and Budget requires certain DoD entities, including the U.S. Army Corps of Engineers, Civil Works to prepare audited financial statements. Prior financial statement audits of the U.S. Army Corps of Engineers, Civil Works have resulted in disclaimers of opinion because of material deficiencies in the statements and supporting information.

This report addresses the accumulated depreciation for buildings and structures that the USACE annually reports on its Balance Sheet. On its FY 2002 financial statements, USACE reported the acquisition cost of its buildings and structures as $30.5 billion. Accumulated depreciation of $12.5 billion reduced the net book value of these assets to $18.0 billion. Before the publication of the FY 2002 financial statements, we performed audit work to determine if the amount of accumulated depreciation reported on the financial statements was fairly stated.

Because time constraints precluded USACE from providing sufficient audit-ready evidential material to meet deadlines established by the Office of Management and Budget, we were unable to complete audit work and therefore, did not render an opinion on the USACE FY 2002 Financial Statements. After the Office of Management and Budget deadline, USACE and the Assistant Inspector General for Auditing of the Department of Defense signed a memorandum of agreement. The memorandum outlined agreed-upon audit procedures to allow Office of the Inspector General of the Department of Defense auditors to verify the material line items on the FY 2002 Balance Sheet and beginning balances for the audit of the FY 2003 financial statements. Verifying a beginning balance for accumulated depreciation directly affected one of the material line items on the USACE Balance Sheet.

Results. We were not able to verify the beginning balance for accumulated depreciation. Further, in the process of performing agreed-upon procedures, we identified deficiencies

in the disclosure of information in the notes accompanying the financial statements. Finally, we determined that USACE calculations relative to the "useful life" of a property were not always in compliance with DoD standards.

The $12.5 billion presented in the USACE FY 2002 Financial Statements for accumulated depreciation was not reliable. As a result, the beginning balance for accumulated depreciation to be reported in the USACE FY 2003 Financial Statements could be misstated by as much as $293 million (net). USACE should verify the recorded depreciation for all of its buildings and structures and correct the accumulated depreciation for those assets (finding A).

We concluded after reviewing the notes to the FY 2002 financial statements, that USACE did not adequately disclose the relationship between itself and the Power Marketing Administrations. Because of these disclosure omissions, the financial statements did not provide relevant information about the USACE business operation. USACE should provide adequate disclosure in the financial statement for those accounts affected by the relationship between the assets owned and operated by USACE, and the Power Marketing Administrations' marketing of the electrical power derived from some of these assets (finding B).

USACE did not comply with the guidance pertaining to "useful life" contained in the DoD 7000.14-R, "DoD Financial Management Regulation," August 2000, when depreciating its buildings and structures. As a result, USACE could be significantly understating accumulated depreciation in its financial statements. USACE should perform a study to determine the true useful life of its assets and request a revision to DoD 7000.14-R, "DoD Financial Management Regulation," for those assets, if necessary. In addition, USACE should verify the accuracy of the useful lives assigned to its assets and update the engineering regulation to include guidance relative to useful life for its Other civil assets (finding C). See the Finding section for the detailed recommendations.

Management Comments and Audit Response. The Commander, U.S. Army Corps of Engineers concurred with using the depreciation variance report to identify the assets that required adjustments to the recorded accumulated depreciation and made $489 million in adjustments to the FY 2003 depreciation amount. However, we request that USACE assert to the Inspector General of the Department of Defense auditors whether all required adjustments were made. For the districts where substantial variances still exist between the depreciation variance report and recorded depreciation, we request that USACE provide the results and reasons for the remaining variances to the Office of the Inspector General of the Department of Defense for review and concurrence. We request that the Commander, U.S. Army Corps of Engineers comment on the final report by April 16, 2004. See the Finding sections of the report for a discussion of management comments and the Management Comments section of the report for the complete text of the comments.

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Background

This audit was performed in support of the Chief Financial Officers Act of 1990 (Public Law 101-576), as amended by the Government Management Reform Act of 1994 (Public Law 103-356). As part of the strategy to implement these laws, the Office of Management and Budget requires certain DoD entities, including the U.S. Army Corps of Engineers, Civil Works, to prepare audited financial statements. This report is one of a series resulting from our audits of the U.S. Army Corps of Engineers (USACE), Civil Works financial statements for FY 2002.

When the Inspector General for the Department of Defense (IG DoD) published the, "Independent Auditor's Report on the U.S. Army Corps of Engineers, Civil Works, Fiscal Year 2002 Principal Financial Statements," (Report No. D2003-043), January 2003, we did not report on asset depreciation. We stated that time constraints precluded USACE providing sufficient audit-ready evidential material for the auditors to complete the audit. We went on to state that unfinished audit work would be completed as an agreed-upon procedure.

A subsequent memorandum of agreement between USACE and IG DoD, "Agreed-Upon Procedures to Establish Beginning Balances for the Audit of the U.S. Army Corps of Engineers, Civil Works, FY 2003 Financial Statements," January 8, 2003, outlined procedures to verify material line items on the FY 2002 Balance Sheet. The memorandum also provided for verifying beginning balances in preparation for the audit of the FY 2003 financial statements. For FY 2002, USACE reported $12.5 billion in accumulated depreciation on $30.5 billion of assets for the Buildings, Structures, and Facilities category of General Property, Plant, and Equipment.

The Department of Energy administers four Federally-owned power-marketing agencies in the United States. These include the Western Area Power Administration, the Bonneville Power Administration, the Southeastern Power Administration, and the Southwestern Power Administration. These Power Marketing Administrations (PMAs) sell to Federal and state agencies and to publicly owned utilities. USACE produces and supplies some of the power sold by the PMAs, and approximately one-third of the USACE buildings and structures relate to power production. Finding B discusses matters related to the disclosure of the relationship between USACE and the PMAs.

Objective

The overall audit objective was to determine whether USACE could rely on the ending balance of accumulated depreciation presented in the U.S. Army Corps of Engineers, Civil Works, FY 2002 Financial Statements to establish the beginning balance in the U.S. Army Corps of Engineers, Civil Works, FY 2003 Financial Statements. See Appendix A for a discussion of the scope and methodology of the audit, and Appendix B for prior coverage related to the objective.

A. Reliability of the Accumulated Depreciation Amount Presented in the FY 2002 Financial Statements

USACE cannot rely on the $12.5 billion of accumulated depreciation it reported for buildings and structures in its FY 2002 financial statements to establish the beginning balance for its FY 2003 financial statements. This is primarily because USACE did not comply with generally accepted accounting principles (GAAP) when it converted from the composite to the straight-line method of depreciation for hydropower assets. As a result, the beginning balance for accumulated depreciation in the FY 2003 Financial Statements may be misstated by as such as $293 million (net) if USACE relies on the previously reported FY 2002 ending balance.

Before CEFMS

Depreciable Assets. Beginning in 1993, USACE converted its accounting system from the Corps of Engineers Management Information System (COEMIS) to the Corps of Engineers Financial Management System (CEFMS). At the time of conversion, the USACE buildings and structures assets were divisible into three depreciation categories. These categories were hydropower assets—assets that it used for electrical power production, which the Power Marketing Administrations distribute—revolving fund assets; and the buildings and other civil structure assets. Before the conversion, USACE districts calculated depreciation only for hydropower and revolving fund assets. Table 1 shows the distribution of USACE buildings and structures among the three categories as of September 30, 2002. As of that date, the book cost for hydropower and revolving fund assets totaled $10.7 billion, while the remaining category, Other civil, totaled $19.9 billion. Based on dollar value or quantities, the USACE was not depreciating a majority of its assets before CEFMS.

Table 1. Categories of USACE Buildings and Structures
September 30, 2002
($ Millions)

Category of Assets	No. of Items	Book Cost	Accumulated Depreciation	Net Book Value
Hydropower	24,131	$10,370	($ 3,811)	$ 6,559
Revolving Funds	1,046	313	(123)	190
Other Civil	32,357	19,867	(8,573)	11,294
Total	**57,534**	**$30,550**	**($12,507)**	**$18,043**

Depreciation Methods. While using COEMIS, USACE depreciated hydropower assets based on a composite service life for a group of assets collectively referred to as a feature. (A glossary of terms is included as Appendix C.) Engineer Regulation (ER) 37-2-10, "Financial Administration - Accounting and Reporting - Civil Works Activities," 1 April 1969 supplied the method for calculating the composite life for the feature. The districts used the composite life to calculate the annual depreciation charge for the entire feature rather than calculating depreciation charges on individual assets. That method was a form of composite or group depreciation. Following conversion to CEFMS, the districts used, and continue to use, the straight-line method of depreciation, which calculates depreciation on individual assets rather than on a feature or collection of assets. The change from composite to straight-line depreciation was a change in accounting principle. Both before and after the conversion to CEFMS, USACE used the straight-line method of depreciation for revolving fund assets.

Criteria

Change in Depreciation Method. GAAP [1] in Accounting Principles Board (APB) Opinion No. 20, July 1971, paragraph 9, states that an example of a change in accounting principle is, "…a change in depreciation method…." The authoritative literature specifies a general rule that a change in accounting principle requires an adjustment to the financial statements in the year of the change. That is, the cumulative effect of the change should be reported in the year in which the principle changes.

Correction of an Error. The same Opinion, in paragraph 13, describes errors in financial statements and states, "errors result from mathematical mistakes; mistakes in the application of an accounting principle, or oversight or misuse of facts that existed at the time the financial statements were prepared." Correction of an error requires a restatement of prior period statements used in comparative financial statements.

Reliability of the Reported Accumulated Depreciation Amount

The $12.5 billion presented in the USACE FY 2002 Financial Statements for accumulated depreciation for buildings and structures was not reliable. We sought to verify the reported depreciation by comparing the amount of depreciation recorded for the assets comprising the $12.5 billion of accumulated depreciation with the amount calculated using the straight-line method. We determined that the principal reason for the differences was that when USACE changed from composite to straight-line depreciation of individual assets, it did not make the required accounting adjustments.

[1] The primary GAAP source relating to the change in depreciation methods and the accounting response is contained in Accounting Principles Board Opinion No. 20, "Accounting Changes," July 1971. While the Opinion establishes that a change in depreciation method is a change in accounting principle, it also defines a correction of an error. Further, it establishes what responses to take for both a change in accounting principle and correction of an error.

Compliance with Generally Accepted Accounting Principles

USACE did not comply with GAAP when it converted from the composite to straight-line method of depreciation. The conversions took place district-by-district over several years beginning in December 1993 and concluding in March 1998. The appropriate accounting response under these circumstances would have been for each district to make the cumulative adjustment. The converting district should have recalculated depreciation for each of the individual assets using the straight-line method of depreciation, compared the calculated amount with the recorded amount, and totaled the differences for all the hydropower assets. The combined differences for the individual hydropower assets would have been the amount to record as a cumulative adjustment. Along with the cumulative adjustment, the districts should have adjusted the amount of accumulated depreciation for each asset at the beginning of the year in which the conversion took place.

USACE Calculations. During the change to CEFMS, each converting district began separately depreciating the individual assets as opposed to depreciating them together as a feature. The resulting total depreciation from a feature was then allocated to each of the individual assets. Once the individual asset was loaded into CEFMS, the system began to calculate all future depreciation charges on a straight-line basis. In addition, the districts began to depreciate previously un-depreciated "other civil assets." The districts calculated and recorded a catch-up amount for the depreciation that they should have recorded for each asset as of the end of the fiscal year preceding the conversion.[2] Once the catch up amount was loaded into CEFMS, the system performed the calculations for the depreciation expense during the conversion year.

Depreciation Allocation. Thirteen of the 14 districts with hydropower assets did not adjust the accumulated depreciation for the hydropower assets to the amount that they should have accumulated, had the straight-line method been in place since the date the asset entered service. Rather, they split up the features' assets, established individual records for the assets and allocated the existing accumulated depreciation for the feature to the individual assets. Documents provided by the districts clearly showed that the amount of accumulated depreciation calculated using the old and new depreciation methods was not the same, that is, an adjustment was required to modify the recorded amount to the amount that would have been recorded had the new method been used since the asset was placed-in-service.

[2] APB No. 20 states in paragraph 13 that a change from a not generally accepted accounting principle to one that is generally accepted is a correction of an error. In general, depreciation is appropriate for long-lived assets and the change from not depreciating other civil assets to depreciating them meets the definition of correction of an error. However, the DoD policy on depreciating general property, plant, and equipment before 1998 only required depreciation on assets used by the Defense Business Operations Fund activities and USACE was therefore in compliance with the DoD policy.

Hydropower Depreciation Balances

Estimating Accumulated Depreciation. Because USACE did not make the required adjustments, USACE may have misstated the accumulated depreciation for hydropower assets in its financial statements by at least $293 million (net). The absolute value of the differences for the assets that comprise the $293 million (net) amount is $673.2 million. To estimate the $293 million (net) we relied on the calculations of a report that exists within CEFMS and which is available to each of the USACE districts. The depreciation verification report (DEPREVER) calculates the straight-line depreciation for each individual asset possessed by the district. The report then compares the amount of recorded depreciation in CEFMS with the amount calculated on a straight-line basis. For each asset, the report displays both the amount of depreciation difference and the percent of difference. Each month the calculated amount increases when the district runs the report because the calculation uses the months in service times a monthly rate.[3] In order to comply with our recommendations, USACE will have to modify the report to calculate the number of months in service as of September 30, 2001, rather than the month the report is run. USACE officials have stated that they modified the report to calculate the months in service as of September 30, 2001.

Variables Affecting Depreciation Calculations. The accuracy of both the CEFMS and DEPREVER report depreciation calculations were dependent on variables that we did not verify when we determined the difference between the recorded and straight-line depreciation. One significant variable was the book cost for assets that entered service before the conversion to CEFMS. The book cost of these assets may include improvements that the district had not separately recorded in CEFMS, and which, therefore, are not recognized for the DEPREVER report calculation. Two other variables CEFMS and the DEPREVER report used for depreciation calculations were the placed-in-service date and the asset useful life. We discuss the useful life variable in finding C of this report.

Unrecorded Improvements. Unrecorded improvements to an asset, which may be included in an asset's book cost, can cause estimated depreciation to vary widely from the recorded depreciation. Presumably, USACE used the asset value, including improvements completed before converting to CEFMS, to calculate the accumulated depreciation recorded at the time of conversion.[4] Assets with improvements completed before USACE converted to CEFMS would generally have less recorded accumulated depreciation than the DEPREVER calculated amount. The reason for this difference is that the DEPREVER report assumes that the entire book cost, except for assets with additions and betterments recorded in CEFMS, should be depreciated from the

[3] For an asset without a recorded addition and betterment, the monthly rate is simply the book cost less its salvage value divided by the service or useful life. The monthly rate is constant unless the useful life, salvage value, or book cost changes; for example, the book cost increases because of an addition or betterment.

[4] If USACE calculated the pre-CEFMS asset value properly, the depreciation for the asset would only depreciate the improvement from the time the improvement was completed. That being true, the accumulated depreciation at the time of conversion would have been less than the amount derived from a simple straight-line calculation that used a book cost that was the total of the original acquisition cost and the cost of the betterment and the initial or original acquisition date.

date the asset was placed-in-service. Accordingly, if part of the book cost—the addition and betterment cost—was from a date later than the date the asset was placed-in-service, the DEPREVER report overstated the calculated depreciation amount. However, improvements completed after conversion to CEFMS should be separately recorded in CEFMS, and consequently the DEPREVER report properly accounts for them when calculating straight-line depreciation.

Placed-in-Service Dates. Another significant variable in the calculation of depreciation is the placed-in-service date. The date recorded in CEFMS may not have been the date originally used to calculate the depreciation accumulated before USACE converted to CEFMS. Even with no improvements or changes in depreciation life, different dates designated as placed-in-service dates will result in a different accumulated depreciation amount for the same asset. Our conclusion is that the DEPREVER provides a legitimate baseline against which to compare recorded depreciation, but that USACE must compare and verify the accumulated depreciation for each asset individually.

Non-Hydropower Assets

Significant unexpected variances between the calculated and recorded depreciation also exist for non-hydropower assets that USACE, with the exception of revolving fund assets, was not depreciating before converting to CEFMS; and for which the only depreciation method has been the straight-line method. Although our audit fieldwork concentrated on the depreciation variances for hydropower assets, an examination of the information in the DEPREVER reports indicates that differences between the recorded depreciation and calculated depreciation amounts are not limited to hydropower assets. For example, for the 14 districts with hydropower assets, the net difference for hydropower assets was $293 million. Those same districts also had non-hydropower assets. When we combined the non-hydropower and hydropower assets' differences for the 14 districts, the net difference between the recorded and calculated amounts was $299.7 million. The remaining districts that did not have hydropower assets also had variances between the recorded and calculated depreciation amounts. Because the assets in these districts were limited to revolving fund or other civil assets, the change in accounting principle cannot be the cause of these differences. Based on our limited analysis, the recorded depreciation amounts vary from the straight-line calculated depreciation amounts by approximately $49.7 million (net) in excess depreciation for non-hydropower assets exclusive of revolving fund assets. Although the differences occurred primarily at three districts, all districts had some variances.

Necessary USACE Action

USACE should not just substitute the DEPREVER calculation for the accumulated depreciation amount for each asset. If the book cost of an asset contains an improvement that was completed before the CEFMS conversion, or if the placed-in-service date is not correct; an adjustment will be required to establish the correct amount of depreciation as of September 30, 2001. Once USACE corrects the amount of depreciation in CEFMS, USACE must then

recalculate the depreciation expense for FYs 2002 and 2003 based on item-by-item corrections.

Because 13 districts did not make the required adjustments at the time of conversion to CEFMS, the change now required is a correction of an error rather than a cumulative adjustment. The practical impact of treating the adjustment as a correction of an error is that USACE will need to correct both the FYs 2002 and 2003 depreciation amount. That is, correction of an error requires a restatement of any prior years used in comparative financial statements. Before it can correctly calculate depreciation for both FY 2002 and FY 2003, USACE must adjust accumulated depreciation for all its buildings and structures to the amount that should have been recorded as of September 30, 2001.

The method CEFMS uses to calculate monthly depreciation expense makes it necessary for USACE to first adjust accumulated depreciation to September 30, 2001. CEFMS calculates the monthly expense by dividing the net book value of the asset by the number of months of remaining service life. Net Book Value is the book cost, less accumulated depreciation and salvage value. Remaining service life is the assigned service life of the asset less the number of months the asset has already been in service. Consequently, when the net book value is misstated, the monthly calculation for depreciation expense will also be wrong. Because the districts did not change the accumulated depreciation for hydropower assets at the time of conversion, the accumulated depreciation was incorrect as of September 30, 2001. As a result, the FY 2002 depreciation expense, which will be included as part of the FY 2003 financial statements, was wrong and must be corrected. Similarly, USACE districts without hydropower assets or those districts with both hydropower and non-hydropower assets will have to adjust depreciation for non-hydropower assets to the amount that they should have accumulated to September 30, 2001, and recalculate the expense for FY 2002 and FY 2003. Corrections to the depreciation amounts for these assets is also a correction of an error and requires that USACE restate the prior year statements used for comparative purposes.

Summary

When USACE converted to CEFMS, it changed its method for depreciating hydropower assets. USACE then started depreciating other civil assets such as buildings and structures that were not considered revolving fund or hydropower assets. A change in depreciation method is defined by GAAP as a change in accounting principle. The proper accounting treatment when changing the depreciation method is to make a cumulative adjustment for the difference between the recorded amount of depreciation, and the amount that would have been recorded, had the new method been in effect since the asset was placed-in-service. The USACE districts did not make the required cumulative adjustment and, as a result, the amount of accumulated depreciation currently recorded for hydropower assets is significantly, and possibly materially, misstated. USACE districts without hydropower assets and those districts with both hydropower and non-hydropower assets have variances for non-hydropower assets that should be examined and corrected. Correction of the variances for hydropower assets will require each USACE district to review the accumulated depreciation for each asset rather than simply substituting the DEPREVER straight-line calculated

amount. USACE cannot just substitute the DEPREVER calculation because if the book cost of an asset includes an improvement completed before the CEFMS conversion, a manual adjustment will be required to adjust the beginning CEFMS balance. Because each district did not make the required adjustment at the time of conversion, the change now required is a correction of an error rather than a cumulative adjustment. The practical impact of treating the adjustment as correction of an error is that USACE will need to correct the FY 2002 depreciation expense as well as the FY 2003 expense. That is, correction of an error requires a restatement of any prior years used in comparative financial statements. For the non-hydropower assets and non-revolving fund assets, the districts should be able to rely on the DEPREVER calculation to supply the amount of depreciation to record because the straight-line method is the only method that USACE has used to depreciate these assets. Revolving fund asset adjustments are subject to a constraint similar to the hydropower assets, that is, any improvements completed before the CEFMS conversion must be considered before adjusting the recorded depreciation.

Recommendations, Management Comments, and Audit Response

A. We recommend that the Commander, U.S. Army Corps of Engineers:

1. Modify the depreciation variance report to calculate the amount of accumulated straight-line depreciation that should have been accrued as of September 30, 2001.

Management Comments. The Commander, USACE concurred and stated that the depreciation variance report was modified to calculate the amount of accumulated straight-line depreciation accrued as of September 30, 2001.

2. Compare the accumulated depreciation for each asset with the amount calculated in Recommendation 1. and determine if an adjustment to the accumulated depreciation is appropriate.

Management Comments. The Commander, USACE concurred and stated that the necessary reviews were performed and that over $489 million in adjustments were made. The details of the adjustments were provided to the IG DoD.

Audit Response. The U.S. Army Corps of Engineers comments were responsive. However, we questioned the completeness of the review, particularly for Power Marketing Administration districts such as Walla Walla. We request that USACE assert to the IG DoD auditors whether all required adjustments were made. For districts where substantial variances still exist between the depreciation variance report and the recorded depreciation, we request that USACE provide the results and reasons for the remaining variances to the Office of the Inspector General of the Department of Defense for review and concurrence.

3. Adjust the accumulated depreciation for each asset for which there is a difference identified in Recommendation 2. to the amount that should have been recorded as of September 30, 2001.

Management Comments. The Commander, USACE concurred and made over $489 million in adjustments.

Audit Response. The U.S. Army Corps of Engineers comments were responsive. However, we request that USACE assert to the IG DoD auditors whether all required adjustments were made. For districts where substantial variances still exist between the depreciation variance report and the recorded depreciation, we request that USACE provide the results and reasons for the remaining variances to the Office of the Inspector General of the Department of Defense for review and concurrence.

4. Recalculate the FYs 2002 and 2003 depreciation amount based on the net book value and number of useful life months remaining as of September 30, 2001.

Management Comments. The Commander, USACE concurred and made over $489 million in adjustments to the FY 2003 accumulated depreciation amount. This adjustment corrected the FY 2003 ending balance and FY 2004 beginning balance for accumulated depreciation.

Audit Response. The U.S. Army Corps of Engineers comments were responsive. However, we request that USACE assert to the IG DoD auditors whether all required adjustments were made. For districts where substantial variances still exist between the depreciation variance report and the recorded depreciation, we request that USACE provide the results and reasons for the remaining variances to the Office of the Inspector General of the Department of Defense for review and concurrence.

5. Disclose the FY 2002 restatement as a footnote to the FY 2003 financial statements.

Management Comments. The Commander, USACE concurred and stated that the USACE will footnote the depreciation adjustment in their FY 2004 financial statements.

Audit Response. The U.S. Army Corps of Engineers comments were responsive. However, we request that USACE assert to the IG DoD auditors whether all required adjustments were made. For districts where substantial variances still exist between the depreciation variance report and the recorded depreciation, we request that USACE provide the results and reasons for the remaining variances to the Office of the Inspector General of the Department of Defense for review and concurrence. We do accept the fact that the FY 2003 financial statements had been published as of the issuance of the responses to the draft of this report. Therefore, we accept the footnote to the FY 2004 financial statements.

B. Disclosure of the U.S. Army Corps of Engineers and the Power Marketing Administration Relationship

USACE did not adequately disclose its relationship with the PMAs in USACE FY 2002 financial statement notes. The relationship entails the PMAs' use of some of the assets owned and operated by USACE to market electrical power produced by USACE. The disclosures in the Management and Discussion Analysis overview section of the financial statements were inadequate because USACE did not update and enhance the PMA information. As a result, USACE has not met the characteristics of understandability, relevance, consistency, and comparability in its disclosure of the USACE and PMA relationship in the financial statements. In particular, the omission of significant and material accounting information regarding USACE and the PMAs distorted the financial report information.

Criteria

The Statement of Federal Financial Accounting Concepts, No. 1: "Objectives of Federal Financial Reporting," Chapter 6: "Qualitative Characteristics of Information in Financial Reports," September 2, 1993, paragraph 156 states:

> Financial reporting is the means of communicating with those who use financial information. For this communication to be effective, information in financial reports must have these basic characteristics: understandability, reliability, relevance, timeliness, consistency and comparability.

Specific note disclosure criteria within the DoD 7000.14-R "DoD Financial Management Regulation," volume 6B, chapter 10, January 2002, that would apply to the disclosure omissions are as follows:

- Note 10. General Property, Plant, Equipment, Net. Section 101202. F. Other Information states, "Disclose on line 2 of this note other information necessary to understand the General PP&E line item on the reporting entity's Balance Sheet."

- Note 1G. Accounting For Intragovernmental Activities. Section 100302 states, "Each reporting entity shall review its financial processes, systems and data, and modify and expand, as necessary, the sample disclosure statement so that each statement is a complete and accurate representation of the issue being addressed."

- Note 19F. Exchange Revenue. Section 102118 states, "Reporting entities that provide goods and services to the public or another government entity shall disclose specific information relating to the pricing policies and any expected losses under goods made to order."

- Note 24. Other Disclosures. Section 102604 states, "Any additional disclosure deemed necessary by the reporting entity in order to provide a better understanding of information presented elsewhere in the statements shall be numbered consecutively 24B, 24C, etc."

Adequacy of Disclosed Information

The FY 2002 financial statements did not contain adequate disclosure of the relationship between USACE and the PMAs. Specifically, USACE did not disclose the following information.

- The financial statements should disclose the significance and materiality of the PMA related assets. There are 24,000 individual PMA related assets within the USACE asset universe of 57,000 items. These PMA related assets are valued at $10.3 billion in comparison to the total USACE real property asset value of $30.5 billion.

- USACE maintains separate accounting records within CEFMS in order to prepare annual financial statements, and to report this financial statement data for the 75 separate power projects to the PMAs.

- The PMAs submitted revenue to the U.S. Treasury on behalf of USACE. The revenue was derived from sales of power generated by USACE assets. In the USACE 2002 Annual Report, USACE reported the revenues in the Management Discussion and Analysis, Profile of Civil Works, Business Programs Section, but not in the financial statement notes section. The Management Discussion and Analysis section stated, "In FY 2002 the Federal PMAs returned $700 million to the U.S. Treasury from power sales." We think that USACE should report financial information of this magnitude in the notes section of the financial statements.

- USACE received direct appropriation funding from the Bonneville PMA for operations and maintenance costs of the USACE assets related to the Bonneville PMA power projects. In December 1997, Bonneville and USACE entered into a ten-year agreement for direct funding that is expected to result in roughly $100 million per year in direct payments by Bonneville, beginning in fiscal year 1999.

Past Disclosures

These disclosure omissions occurred because in prior financial statements, the Army Audit Agency made the disclosure about the significance and materiality of PMA related assets but not about the financial statement preparation and

revenues. It is probable that USACE did not report PMA related asset information in FY 2002 because USACE had not reported this information in the past.

Importance of the Relationship

The USACE financial statements, as written, do not make readers aware of the magnitude and materiality of USACE involvement with power production. Furthermore, in respect to the revenue submissions and direct appropriation funding by the PMAs, the omission of this important financial information serves to distort the true financial picture of USACE.

Conclusion

USACE has not met the characteristics of understandability, relevance, consistency, and comparability in the financial statements in its disclosure of the USACE and PMA relationships. In particular, the omission of significant and material accounting information regarding the USACE and PMAs has resulted in ineffective communication on financial report information.

Recommendations and Management Comments

B. We recommend that the Commander, U.S. Army Corps of Engineers

1. Disclose in the financial statement notes those accounts affected by the relationship between the assets owned and operated by the U.S. Army Corps of Engineers and the Power Marketing Administrations' marketing of electrical power derived from some of these assets. Specifically, the U.S. Army Corps of Engineers should disclose:

a. Significance and materiality of Power Marketing Administration related assets in Note 10, General Property, Plant, and Equipment, Section F. Other Information.

b. Maintenance of separate accounting records and preparation of individual financial statements for 75 separate power projects in Note 1G, Accounting for Intragovernmental Activities.

c. Revenue submissions made by the Power Marketing Administrations on behalf of the U.S. Army Corps of Engineers in Note 19F, Exchange Revenue.

d. Direct appropriation funding made by the Power Marketing Administrations in Note 24, Other Disclosures.

Management Comments. The Commander, USACE concurred and stated that they disclosed the facts as appropriate in the footnotes of the FY 2003 Financial Statements or the Management Discussion and Analysis section of the FY 2003 Financial Statements.

2. Provide a detailed explanation of the relationship between U.S. Army Corps of Engineers and Power Marketing Administrations in the Management Discussion and Analysis section of the financial statements.

Management Comments. The Commander, USACE concurred and stated that the relationship between USACE and the Power Marketing Administration was further explained in their FY 2003 Management Discussion and Analysis section of the FY 2003 Financial Statements.

C. Asset Useful Life

USACE did not comply with the DoD 7000.14-R, "DoD Financial Management Regulation," (FMR), August 2000 guidance concerning what "useful life" periods to use when depreciating its buildings and structures, such as dams, locks and hydropower generation assets. This occurred because USACE established its own useful life tables for both hydropower and revolving fund assets, asserting that it followed the Federal Energy Regulatory Commission guidelines for asset useful life periods. In addition, USACE did not establish useful life period tables for "Other Civil" assets. As a result, the accumulated depreciation shown in USACE financial statements would be understated by as much as $8.2 billion if the DoD maximum useful life periods policy of 40 years was followed.

Depreciation Useful Life Guidance

DoD Guidance. DoD guidance for depreciation in relation to useful life is contained in the "DoD Financial Management Regulation" volume 4, chapter 6, "Property, Plant, and Equipment," August 2000. For computing depreciation on General PP&E, the "DoD Standard Recovery Periods Table," prescribes recovery (useful life) periods of 5, 10, 20, and 40 years. It also permits depreciation over a period of less than 5 years under limited conditions. (See Appendix D for the table.)

USACE Guidance. The USACE depreciation guidance is set forth in ER 37-2-10, "Financial Administration - Accounting and Reporting - Civil Works Activities," April 1, 1969. ER 37-2-10 prescribes the accounting systems and related procedures for all USACE civil works activities. It is applicable to all division and district offices. Although USACE first published ER 37-2-10 on April 1, 1969, it has since changed the regulation 89 times. USACE updated most of the tables prescribing depreciation intervals in 1995, although some of the useful life guidance is dated to 1991.

Specific USACE guidance concerning useful lives is in ER 37-2-10, chapter 15, Appendix B, "Minimum and Maximum Useful Life Years," October 1, 1991, and chapter 31, Appendix A, section 31-A-5, "Plant Items," April 21, 1995. Chapter 15 includes policy for revolving fund structures, which vary from a maximum of 10 years for a temporary structure, to 20 to 50 years for permanent structures. The information in chapter 31 is more detailed and includes intervals up to 100 years. USACE district personnel assign useful lives to assets by reference to ER 37-2-10.

USACE Compliance with Guidance

USACE did not comply with FMR guidance concerning what useful life periods to employ for depreciating its buildings and structures. Table 2 shows the useful life periods USACE was using and the number and dollar value of the assets in each useful life grouping. USACE was depreciating more than 75 percent of its assets with useful life periods that exceeded the DoD maximum of 40 years. From a dollar perspective, USACE was depreciating more than 93 percent of its assets employing useful life periods that exceeded the DoD maximum.

Table 2. Buildings & Structures Universe
September 30, 2002
($ Millions)

Useful Life (Years)	Number of Properties	Percent of Total Number	Book Cost	Percentage of Total Cost
0 - 40	14,110	24.5%	$ 2,108	6.9%
40 - 50	24,544	42.7%	9,987	32.7%
50 - 75	365	0.6%	631	2.1%
75 - 100	18,475	32.1%	16,975	55.5%
100 +	40	0.1%	848	2.8%
Total	**57,534**	**100.0%**	**$30,549**	**100.0%**

FMR Prescribed Useful Lives. USACE was not employing the FMR prescribed useful life periods. USACE has never asked for a waiver from the useful life criteria in the FMR. In addition, the useful life periods that USACE did employ were not generally in consonance with other Government or private sector useful life periods. For example, the Department of Energy stated in its, "Performance and Accountability Report, FY 2001," that for structures and facilities, it used depreciation intervals of 25-50 years. In addition, in October 2002, the General Accounting Office (GAO) reported the results of its survey of capitalization and useful life policies for both private sector and Government organizations.

GAO Survey Results. The GAO results are described in GAO-03-42, "Financial Management-Survey of Capitalization Threshold and Other Policies for Property, Plant and Equipment," October 15, 2002. The GAO surveyed policies in both private sector and Government organizations. GAO found that most organizations within the private sector apply a maximum useful life of between 40 and 50 years for buildings, and between 30 and 40 years for other structures. The same survey showed that most Government organizations have a maximum useful life of between 30 and 40 years for buildings and between 20 and 40 years for other structures. The report notes that the Federal Accounting Standards Advisory Board does not prescribe specific classifications of estimated useful life periods. Instead, it requires that useful life consider economic, environmental, and technological factors such as physical wear and tear and obsolescence.

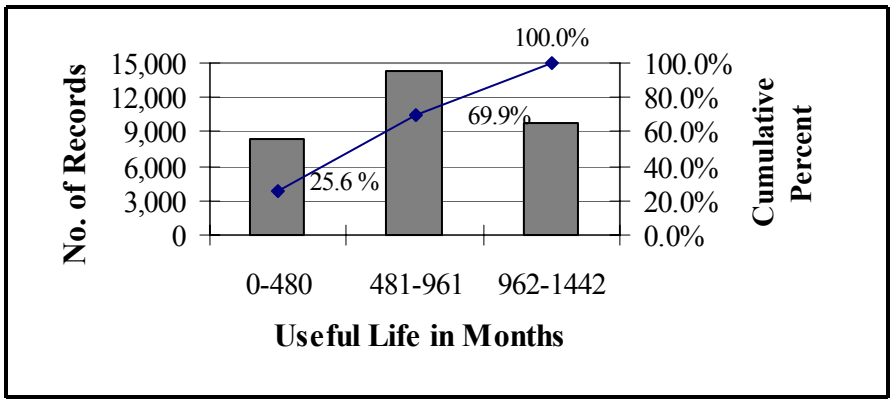
GAO also identified several policy differences attributable to the variety of assets owned by the entities that participated in its survey, rather than any systematic differences in useful life classifications.

Foundation for USACE Guidance

USACE had established its own useful life tables for both hydropower and revolving fund assets, asserting that it followed the Federal Energy Regulatory Commission guidelines for useful life.[5] As discussed in Finding A, USACE was primarily depreciating the hydropower category of assets before it converted to CEFMS in the 1990s. In our discussions with the USACE staff about the useful life periods they were using, the staff asserted that USACE had established the useful life periods years ago in consultation between its staff and the Federal Energy Regulatory Commission staffs. However, USACE was not able to provide documentation to support its assertions.

Further surrounding the basis for the USACE useful life intervals is the absence of guidance in ER 37-2-10 about what useful lives to employ for depreciating the non-hydropower and non-revolving fund assets labeled as "Other Civil" assets in Table 1. While chapter 15 contains guidance for the revolving fund assets and chapter 31 for hydropower assets, ER 37-2-10 has no specific chapter for the two-thirds of the assets that are not revolving fund or hydropower assets. By inspection of the other civil assets useful lives, we can state that the useful lives for these assets are also not in compliance. The 57,534 items shown in Table 1 include 32,357 [6]assets that are other civil assets. Figure 1 shows that of the 32,357 assets, only 25.6 percent have an assigned useful life of 40 years (480 months) or less, the DoD maximum useful life.

Figure 1. Useful Life Assigned to USACE Other Civil Assets



[5] The Financial Management Regulation (FMR) table of recovery periods (useful life periods) presented at Appendix C was not published until 1998. Before that date, the FMR stated that useful life was not based on a standard table of useful life periods, but on actual or planned retirement or replacement practices. The FMR guidance published in 1995 did, however, limit the maximum useful life to 40 years; USACE should have modified its useful life tables to not exceed 40 years, or have requested a waiver.

[6] To facilitate presentation, two items included in the total of 32,357 assets in the other civil category shown in Table 1 with an assigned useful life of greater than 1442 months were excluded from the chart.

Because of the relationship between USACE and the Power Marketing Administrations, there may be a supportable basis for considering Federal Energy Regulatory Commission guidance as a foundation for establishing useful lives for hydropower assets; however, the case is weakened for other civil assets.

Noncompliance with ER 37-2-10. We performed two tests of controls over the establishment of useful life. The first test was to ensure that the asset had a useful life of 2 years or greater and the second test was to determine whether the useful life recorded in CEFMS matched the useful life prescribed in ER 37-2-10. During our fieldwork, we statistically sampled 80 records from a universe of 5,842 records. These records were part of the total universe of 57,534 records for buildings and structures, but our sample universe was limited to those records that had changed between October 1, 1999, and September 30, 2002. Of the 80 buildings or other structures still in use as of September 30, 2002, we tested 50 for proper controls in establishing the asset's useful life. The remaining 30 assets were either not in service as of September 30, 2002, or were no longer physically present.

All 50 assets had useful lives greater than 2 years. Eleven of the 50 failed control testing because the useful life in CEFMS differed from ER 37-2-10 chapter 31, Appendix A. Nine of the eleven buildings and structures had a useful life less than what was required by ER 37-2-10, chapter 31, Appendix A. The remaining two assets had a useful life greater than prescribed in ER 37-2-10 chapter 31, Appendix A. Based on these results, USACE has yet to direct the districts to validate the current useful lives to determine if the assigned useful lives are in substantial compliance with ER 37-2-10 guidance.

USACE Uncommon Items. USACE does possess some real property assets for which longer useful lives may be appropriate. These assets such as dams, locks, levees, and hydropower generation assets do not readily fit within the useful life categories in the DoD table at Appendix C, and USACE should consider asking for a waiver from the DoD requirements. However, only assets that have a demonstrated useful life longer than the DoD prescribed 40 years should have longer useful life established; that is, if the asset clearly does not fit within the DoD categories. USACE should perform a study of these assets to determine and establish meaningful useful lives for depreciating the assets. Once established, USACE should seek either a waiver from the DoD Comptroller or a change to the FMR to incorporate useful lives for these assets.

Consequence of Longer Useful Lives

As a result of not complying with DoD policy guidance on useful lives, the USACE accumulated depreciation shown on its financial statements could be understated by as much as $8.2 billion, (based upon useful life not exceeding 40 years, the DoD maximum). However, USACE asserts that the depreciation intervals in the FMR are not appropriate for some of its assets. While we offer no conclusion about this assertion, we recommend that USACE demonstrate that the DoD FMR intervals are not appropriate for some of its assets and, further, what intervals are appropriate for those same assets, as well as the "other civil" assets.

Conclusion

Useful life policies should ensure that USACE depreciates its assets over a reasonable useful life and hence allocate depreciation expense to the appropriate period. USACE should base decisions about useful life on a reasonable estimate of how long an asset can actually be used. A majority of the assets currently in the USACE buildings and structures account can reasonably comply with the useful life established by DoD regulation and should not be exempt from these requirements. However, the USACE has assets that, while currently in use, have already exceeded the useful lives established by the DoD policy guidance, and require longer useful lives to be established. We think that assets such as dams, dikes, power plants, etc, should have useful lives established for them. However, these useful lives need to be formally established, approved by the DoD Comptroller, and used sparingly.

Recommendation and Management Comments

C. We recommend that the Commander, U.S. Army Corps of Engineers:

1. Perform a study to establish which U.S. Army Corps of Engineers assets should not be depreciated using the useful lives established by the Financial Management Regulation, and determine the appropriate useful life (operational) for U.S. Army Corps of Engineers assets such as dams, bridges, and hydropower generation assets.

Management Comments. The Commander, USACE concurred and noted that the USACE has undergone a study to determine the appropriate useful life for all USACE-owned assets and will provide the results to the IG DoD when completed for review and concurrence.

2. Upon completion of the study in Recommendation C.1. request either a waiver from the Financial Management Regulation requirements or else a revision of the Financial Management Regulation to incorporate the additional depreciation useful lives.

Management Comments. The Commander, USACE concurred and stated that with the completion of the study, USACE will request a waiver from the DoD Financial Management Regulation.

3. Develop a plan to select a random sample of buildings and structures in order to verify that assigned depreciation intervals are consistent with policy guidance.

Management Comments. The Commander, USACE concurred and agreed to develop a plan to verify that the assigned depreciation intervals are consistent with the new policy, which will be written based on the results of the study.

4. Change ER 37-2-10 to incorporate the DoD 7000.14-R, "DoD Financial Management Regulation," useful life standards to include specific guidance for the depreciation of other civil assets.

Management Comments. The Commander, USACE concurred and noted that once the study is completed and agreed to by the IG DoD, USACE will request a waiver from the DoD Financial Management Regulation based on USACE-unique mission requirements.

Appendix A. Scope and Methodology

This is one in a series of projects to perform agreed-upon procedures to verify beginning balances for the audit of the U.S. Army Corps of Engineers, Civil Works, FY 2003 Financial Statements. Originally, our review was limited to verifying the FY 2003 beginning balance for the accumulated depreciation of the USACE buildings and structures and was dependent upon other audit teams to verify the acquisition cost and in-service dates for those assets. We identified and analyzed the variances between the amount of reported depreciation and the amount of expected straight-line depreciation, which is the depreciation method USACE uses to depreciate its buildings and structures. During the course of our audit fieldwork, we identified deficiencies in the financial statement disclosures and added work concerning financial statement disclosures to our fieldwork and reporting.

We reviewed Statements of Federal Accounting Concepts No. 1, "Objectives of Federal Financial Reporting," September 1993; Statements of Federal Financial Accounting Standards No. 6, "Accounting for Property, Plant, and Equipment," November 1995; Statements of Federal Financial Accounting Standards No. 21, "Reporting Corrections of Errors and Changes in Accounting Principles;" and Accounting Principles Board No. 20, "Accounting Changes," July 1971. We reviewed the Corps of Engineers Regulation 37-2-10, chapter 15,"Revolving Fund Fixed Asset Accounting," October 1991; and chapter 31, "Accounting Treatment for Multiple-Purpose Projects," April 1994 as well as the USACE conversion manual, appendix L, "Multi-Purpose Power Accounting", August 1996. We also reviewed the DoD Financial Management Regulation, volume 4, chapter 6, "Property, Plant, and Equipment," August 2000. We reviewed the Corps record retention and accounting policies, and we considered the reports of the independent auditors of the power marketing administrations in our review of the USACE relationship to the Power Marketing Administrations.

Our team visited five USACE districts - Baltimore, Maryland; Walla Walla, Washington; Portland, Oregon; Huntington, West Virginia; and Nashville, Tennessee. We also held meetings with headquarters personnel in Washington, D.C. Our work included procedures to evaluate the reasonableness of the CEFMS buildings and structures data received from IG DoD auditors in Indianapolis, Indiana and provided by the USACE accountants in Huntsville, Alabama. To understand the annual changes in accumulated depreciation, we reviewed current and prior year financial statements and requested a client-prepared schedule of the annual depreciation expense and prior period adjustments. We requested explanations for the depreciation variances of judgmentally selected assets from each of four districts and prepared a schedule of hydropower assets, showing the possible variances between recorded depreciation and straight-line depreciation. Our review of the depreciation verification report's algorithm established that the report provides a valid baseline for the analysis of asset depreciation if the source data is accurate. Finally, we assessed the USACE compliance with the DoD Financial Management Regulation in establishing asset useful lives and we reviewed actions relating to the conversion from COEMIS to CEFMS.

We performed this audit from December 2002 through August 2003 in accordance with generally accepted government auditing standards; however, our scope was limited in that we did not include tests of management controls.

Use of Computer-Processed Data. We used computer-processed data from CEFMS for this audit; however, we were not able to confirm the reliability of the buildings and structures data. The lack of reliable data did not permit us to establish the FY 2003 beginning balance for the accumulated depreciation of the USACE buildings and structures. Other reports on general and application controls have revealed weaknesses in CEFMS.

General Accounting Office High-Risk Area. The General Accounting Office has identified high-risk areas in the Department of Defense. This report provides coverage of the DoD Financial Management high-risk area.

Appendix B. Prior Coverage

During the last 5 years, the General Accounting Office (GAO) and the Inspector General of the Department of Defense (IG DoD) have issued reports related to the U.S. Army Corps of Engineers, Civil Works, Financial Statements. Unrestricted GAO reports can be accessed over the Internet at http:www.gao.gov/**.** Unrestricted IG DoD reports can be accessed at http:www.dodig.osd.mil/audit/reports.

GAO

GAO Report No. GAO-03-42, "Financial Management-Survey of Capitalization Threshold and Other Policies for Property, Plant and Equipment," October 15, 2002

GAO Report No. GAO-02-589, "Corps of Engineers Making Improvements, But Weaknesses Continue," June 10, 2002

GAO Report No. GAO/AMID-00-235, "Computer Control Weaknesses over the Corps of Engineers Financial Management System," September 2000

IG DoD

IG DoD Report No. D-2003-043, "Independent Auditor's Report on the U.S. Army Corps of Engineers, Civil Works, Fiscal Year 2002 Principal Financial Statements," January 6, 2003

IG DoD Report No. D-2001-067, "Inspector General, DoD, Oversight of the Army Audit Agency Audit of the FY2000 U.S. Army Corps of Engineers, Civil Works Program, Financial Statements," February 28, 2001

U.S. Army Audit Agency

Audit Report No. AA 02-142, "Fiscal Year 2001 Financial Statements, U.S. Army Corps of Engineers, Civil Works," February 8, 2002

Audit Report No. AA-01-359, "Audit of the U.S. Army Corps of Engineers FY 00 Financial Statements, Civil Works (Property, Plant, and Equipment Valuation)," June 28, 2001

Audit Report No. AA 01-319, "Corps of Engineers Financial Management System General and Application Controls," June 26, 2001

Audit Report No. AA 01-187, "Fiscal Year 2000 Financial Statements, U.S. Army Corps of Engineers, Civil Works," February 14, 2001

Audit Report No. AA-00-186, "FY99 Financial Statements, U.S. Army Corps of Engineers, Civil Works," February 18, 2000

Audit Report No. AA-99-157, "FY98 Financial Statements, U.S. Army Corps of Engineers, Civil Works," February 8, 1999

Appendix C. Glossary

Accumulated Depreciation is the amount of depreciation expense that has been added over a period of time, calculated from the placed-in-service date of the asset.

Acquisition Cost includes all amounts incurred to bring the asset to a form and location suitable for its intended use. Some examples include: amounts paid to vendors, transportation charges to the point of initial use, and handling and storage costs.

Book Cost is synonymous with acquisition cost.

Composite Depreciation is the term used to describe a method of depreciation for a group of assets, collectively referred to as a feature, and based upon their individual useful life periods.

Feature is a term used to describe a group of assets. Within the USACE context, individual assets have been combined into a unit to facilitate accounting control.

Net Book Value is the acquisition cost (book cost), less the accumulated depreciation and salvage value of the asset.

Other Civil describes the category of assets that are neither hydropower related assets nor Revolving Fund related.

Placed-In-Service refers to the date that an asset is physically complete and available for use. Assets are recognized when title passes to the acquiring entity or when the asset is delivered to the entity or to an agent of the entity. It defines the start of the capitalization and depreciation expense process.

Recovery Period is a term synonymous with useful life period.

Remaining Service Life is the assigned service life of an asset less the number of months the asset has already been in service.

Straight-Line is the depreciation method that allocates the acquisition cost of an asset, equally over the useful life period.

Useful Life Period is the estimated time period for an asset to provide its intended service. The concept recognizes the deterioration of items due to the aging process.

Appendix D. Department of Defense Recovery Periods

DoD RECOVERY PERIODS FOR DEPRECIABLE GENERAL PP&E ASSETS (Excludes National Defense PP&E and Heritage Assets)

Description of General PP&E Assets	Recovery Period
General Purpose Vehicles (Includes Heavy Duty Trucks and Buses); ADP Systems and Hardware (Computers and Peripherals); High Tech Medical Equipment; Equipment used in Research, Development, Test and Evaluation (RDT&E); Radio and Television Broadcasting Equipment; and Software Improvements to 5-Year Recovery Period Property (Personal Property)	5 Years*
All Other Equipment, Machinery and Software** Improvements to 20-Year Recovery Period Property	10 Years
Vessels, Tugs, Barges and Similar Water Transportation Equipment (Non-National Defense PP&E vessels/ships) Steam (12.5K pounds per hour or more) and Electric Generation Equipment (500 Kilowatt or more), Sewers and Other Utilities (including such things as fiber optic cable) Fences, Roads, Bridges, Towers, Ship and Railroad Wharves and Docks, Dry Docks, Fuel Storage Facilities and Other Real Property Structures. Improvements to 40-Year Recovery Period Property	20 Years
Buildings, Hangers, Warehouses, Fuel Storage Buildings, Air Traffic Control Towers, and Other Real Property Buildings	40 Years
Improvements to Leased Buildings and Other Real Property (Leasehold Improvements)	Remainder of Lease Period or 20 Years Whichever Is Less
Land Rights of Limited Duration	Over the Specified Duration

* A recovery period of less than 5 years is permitted when the acquiring DoD Component is certain that the useful life of an asset is at least 2 years but less than 5 years. In such circumstances, the recovery period shall be the known useful life (2-4 years, as appropriate).

** Depending on the nature of the software, it may be depreciated over a period of less than 5 years, 5 years, or 10 years. The determining factor should be the actual estimated useful life of the software consistent with that used for planning the software's acquisition.

Appendix E. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)/Chief Financial Officer
Deputy Chief Financial Officer
Deputy Comptroller (Program/Budget)

Department of the Army

Auditor General, Department of the Army
Commander, U.S. Army Corps of Engineers

Department of the Navy

Naval Inspector General
Auditor General, Department of the Navy

Department of the Air Force

Auditor General, Department of the Air Force

Unified Commands

Inspector General, U.S. Joint Forces Command

Non-Defense Federal Organizations and Individuals

Office of Management and Budget

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

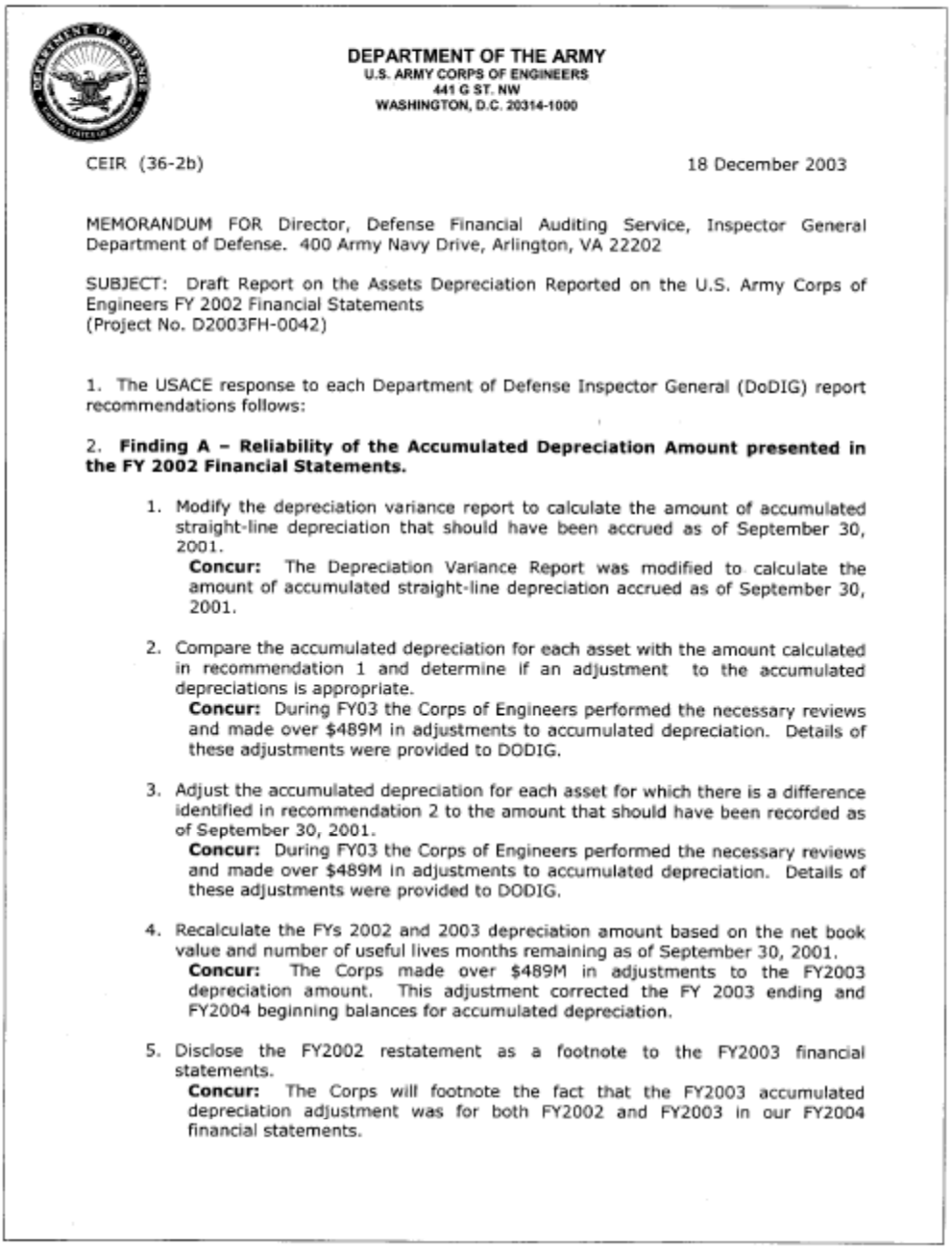
Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Reform
House Subcommittee on Government Efficiency and Financial Management, Committee on Government Reform

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member (cont'd)

House Subcommittee on National Security, Emerging Threats, and International Relations, Committee on Government Reform

House Subcommittee on Technology, Information Policy, Intergovernmental Relations, and the Census, Committee on Government Reform

U.S. Army Corps of Engineers Comments



DEPARTMENT OF THE ARMY
U.S. ARMY CORPS OF ENGINEERS
441 G ST. NW
WASHINGTON, D.C. 20314-1000

CEIR (36-2b) 18 December 2003

MEMORANDUM FOR Director, Defense Financial Auditing Service, Inspector General Department of Defense. 400 Army Navy Drive, Arlington, VA 22202

SUBJECT: Draft Report on the Assets Depreciation Reported on the U.S. Army Corps of Engineers FY 2002 Financial Statements
(Project No. D2003FH-0042)

1. The USACE response to each Department of Defense Inspector General (DoDIG) report recommendations follows:

2. **Finding A – Reliability of the Accumulated Depreciation Amount presented in the FY 2002 Financial Statements.**

1. Modify the depreciation variance report to calculate the amount of accumulated straight-line depreciation that should have been accrued as of September 30, 2001.
   Concur: The Depreciation Variance Report was modified to calculate the amount of accumulated straight-line depreciation accrued as of September 30, 2001.

2. Compare the accumulated depreciation for each asset with the amount calculated in recommendation 1 and determine if an adjustment to the accumulated depreciations is appropriate.
   Concur: During FY03 the Corps of Engineers performed the necessary reviews and made over $489M in adjustments to accumulated depreciation. Details of these adjustments were provided to DODIG.

3. Adjust the accumulated depreciation for each asset for which there is a difference identified in recommendation 2 to the amount that should have been recorded as of September 30, 2001.
   Concur: During FY03 the Corps of Engineers performed the necessary reviews and made over $489M in adjustments to accumulated depreciation. Details of these adjustments were provided to DODIG.

4. Recalculate the FYs 2002 and 2003 depreciation amount based on the net book value and number of useful lives months remaining as of September 30, 2001.
   Concur: The Corps made over $489M in adjustments to the FY2003 depreciation amount. This adjustment corrected the FY 2003 ending and FY2004 beginning balances for accumulated depreciation.

5. Disclose the FY2002 restatement as a footnote to the FY2003 financial statements.
   Concur: The Corps will footnote the fact that the FY2003 accumulated depreciation adjustment was for both FY2002 and FY2003 in our FY2004 financial statements.

CEIR (36-2b) 18 December 2003
SUBJECT: Draft Report on the Assets Depreciation Reported on the U.S. Army Corps of Engineers FY 2002 Financial Statements
(Project No. D2003FH-0042)

3. **Finding B – Disclosure of the U.S. Army Corps of Engineers and Power Marketing Administration Relationship.**

1. Disclose in the financial statement notes those accounts affected by the relationship between the assets owned and operated by the U.S. Army Corps of Engineers and the Power Marketing Administrations marketing electrical power derived from some of these assets. Specifically, the U.S. Army Corps of Engineers should disclose:

   a. Significance and materiality of power market Administration related assets in Note 10, General Property, Plant and Equipment Section F Other Information.
   Concur: The Corps of Engineers disclosed the facts above in the FY 2003 Financial Statements, Footnote 10.

   b. Maintenance of separate accounting records and preparation of individual financial statements for 75 separate power projects in Note 1G, Accounting for Intergovernmental Activities.
   Concur: The Corps of Engineers disclosed the facts above in the FY 2003 Financial Statements management Discussion and Analysis.

   c. Revenue submissions made by the power marketing Administrations on behalf of the U.S. Army Corps of Engineers in Note 19F, Exchange Revenue.
   Concur: The Corps of Engineers disclosed the facts above in the FY 2003 Financial Statements Management Discussion and Analysis.

   d. Direct appropriation funding made by the Power Marketing Administrations in Note 24, other Disclosures.
   Concur: The Corps of Engineers disclosed the facts above in the FY 2003 Financial Statements management Discussion and Analysis.

2. Provide a detailed explanation of the relationship between the U.S. Army Corps of Engineers and Power Marketing Administrations in the Management Discussion and Analysis section of the financial statements.
   Concur: The Corps of Engineers expanded its explanation of the relationship between the Corps and the Power Market Administrations in their FY2003 Management Discussion and Analysis section of the FY 2003 financial statements.

4. **Finding C – Asset Useful Life.**

1. Perform a study to establish which U.S. Army Corps of Engineers assets should not be depreciated using lives established by the Financial Management Regulation, and determine the appropriate useful life (operational) for U.S. Army Corps of Engineers assets such as dams, bridges, and hydropower generation assets.
   Concur: The Corps of Engineers has undergone a study to determine the proper useful lives for all Corps owned assets. Once the study is complete, the

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SUBJECT: Draft Report on the Assets Depreciation Reported on the U.S. Army Corps of Engineers FY 2002 Financial Statements
(Project No. D2003FH-0042)

Corps will provide a copy to DODIG for their review and concurrence. The target completion date for the study is 20 February 2004.

2. Upon completion of the study recommended in C.1. request either a waiver from the Financial Management Regulation requirements or else a revision of the Financial Management Regulation to incorporate the additional depreciation useful lives.
Concur: Once the study recommended above is complete, the Corps intends on requesting a waiver from the DoD Financial Management Regulation due to the Corps unique mission. The target completion date for requesting a waiver is 20 February 2004.

3. Develop a plan to select a random sample of building and structures in order to verify that assigned depreciation intervals are consistent with policy guidance.
Concur: The Corps will develop a plan to select a random sample of building and structures to verify the assigned depreciation intervals are consistent with the new policy being written based on the results of the study mentioned above. The target completion date to develop a plan is 30 June 2004.

4. Change ER 37-2-10 to incorporate the DoD 7000.14R, "DoD Financial Management Regulation", useful life standards to include for the depreciation of other civil assets.
Concur: The study the Corps is currently performing will encompass all Corps of Engineers Civil Works assets to include other civil assets. Once complete, the Corps will provide the DODIG with a copy and request a waiver from the DoDFMR based on the Corps unique mission requirements. The target completion date for the study is 20 February 2004.

5. The POCs for this response are John Templeton (202) 761-1985 or Dora Wilson (202) 761-1926.

FOR THE COMMANDER:

JOHN E. TEMPLETON
Chief, Audit Executive
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